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NF96-267 Hog Cash Contracts

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Hog Cash Contracts

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This NebFact briefly discusses the traditional provisions of a fixed price forward cash contract for a seller of livestock. This review is followed by a listing of the major types of current long-term hog marketing contracts available to hog producers.

Cash Contracts

A seller can negotiate a written forward cash contract with a buyer (most often a packer) for future delivery. This is a legally binding document for both parties. Generally forward cash contracts are onetime contracts (i.e. for a specific lot of hogs, for a specific time period, with a specific buyer).

The buyer will normally take an opposite position in the futures market to offset any price fluctuations before the delivery date. To cover margin and commissions, the contract price offered by the buyer may be lower than corresponding futures prices adjusted for expected basis. The terms of a forward cash contract include:

- The quantity to be delivered;
- acceptable weights, weighing conditions and locations;
- acceptable liveweight or carcass grades, which may include provision for premiums and discounts;
- the location for delivery;
- the date(s) of delivery (the date normally can be changed by mutual agreement. The seller may have the option of selecting the delivery date within a specific time interval – i.e. a particular day during a specific week); and
- the price received, on liveweight or carcass weight basis, fixed base price or possibly a formula price.

Other provisions of the contract may include how nondeliverable animals or unacceptable carcasses are handled, where the livestock are to be inspected (at farm or at buyer location) and provisions dealing with breach of contract. The seller retains all production risks under a fixed price forward cash contract.

Once the contract is signed, the seller has reduced the risk of declining prices and hopefully has locked in an acceptable selling price. However, if prices are higher at delivery time, the producer must fulfill the terms of the contract and receive the negotiated price. The final payment may vary depending on quality or quantity (weight) adjustments based on price premiums or discounts.

Current Long-Term Hog Marketing Contracts

Current long-term hog marketing contracts may have all the elements of a fixed price forward cash contract, but with expansions and refinements and additional price risk sharing between the buyer (most often a packer) and seller. The contracts may be used to guarantee a premium for hogs sold and to insure a consistent long-term buyer. Many contracts establish a floor price, while enabling the producer to ride the market up and benefit from higher prices. Most contracts are written for periods of three to seven years.

The following three long-term hog marketing contracts, with variations, are currently being offered by U.S. hog buyers.

Price Window

These contracts offer a price range with an upper limit and a lower limit. When market hog prices are within this range (limits), the market price is the price paid. When market hog prices are above or below the range, the difference is split between the producer and the buyer. The split is usually subject to negotiation between the producer and the buyer. While some contracts guarantee upper and lower limit prices, a common practice is to split the difference between the market price and the limit price equally between the producer and buyer when the market price falls out of the price range. For example, if the price window is $38 to $48/cwt., the producer would receive the market price when it is between $38 and $48. If the price is $30, the producer receives $34, if it is $56, the producer receives $52.

Cost-Plus *(Also referred to as a formula price contract)*

These contracts try to determine the cost of producing hogs, guaranteeing the hog producers a minimum price above the cost. The cost of production is determined by a production budget and feed price adjustments. For example the contract might use the UNL Swine Enterprise Records high profit one-third cost of production for farrow-finish enterprises as the budget cost and add $5/cwt. as the plus. If the top one-third cost is $40/cwt. and $5/cwt. is added, the price paid is $45/cwt. Current corn and soybean meal prices are figured into the cost of production, making the cost a moving target. The cost of production budget is adjusted for corn and soybean meal price changes. Most often these adjustments are based on five or more week rolling averages of corn and soybean meal at a specific location (i.e. Omaha and Decatur). If the market price is below the guaranteed minimum price, the producer is paid the guaranteed minimum price. If the market price is above the guaranteed price, the difference may be split between buyer and the producer. As feed prices decline, so does the price received for hogs and vice-versa. The cost-plus price is independent of the current market price of hogs. It protects producers from variables beyond their control – hog and feed prices.

Cash-Flow Assistance

This contract establishes a floor price which might be a $43 to $48 window, below which the difference often is split 50/50 (referred to as a 50/50 split on the bottom side) between producer and buyer. However, the buyer's contribution is tracked in an "owed escrow account" which is paid back after prices exceed a specific amount. In this case there would be a $48 ceiling on the base price until the "owed escrow" is erased. After the escrow is paid, the producer receives full market price for hogs sold.

This type of contract often contains a clause extending the contract if the balance in the "owed escrow account" is not zero at the scheduled termination.

Additional Long-Term Contract Terms and Concerns

- May require carcass merit pricing.
- May require a minimum liveweight or carcass grade to qualify for the contract.
- Repeated delivery of sub-standard hogs may be grounds for cancelling contract.
- Scheduled deliveries are required.
- Some contracts allow producer to commit a portion of production.
- Contracts may require producer to commit all production and buyer has first rights on any expansion.
- Contract may require that genetic sources, nutritional practices, facilities and production practices be approved by buyer.
- Contract may have a clause that keeps track of price gains and losses under risk-sharing provisions and it may be continued or bought out if either party has made a net gain. This assures the same long-range average price as the cash market, without highs and lows.

Additional Key Points for Hog Producers

- A producers interest in hog contracts should be quality driven, not quantity driven. Producers must produce high quality hogs.
- Many contracts have additional requirements such as producer must be Pork Quality Assurance Level 3.
- A marketing contract is a legally binding agreement.
- Marketing contracts must be read closely before signing. All implications of the contract must be understood. How much flexibility does the contract offer?
    1. Does contract require all hogs be sold to buyer, or is delivery of a certain number, pounds specified?
    2. If the contract specifies a certain number, what is done with the surplus?
    3. Are reasons for non-performance allowed such as loss of production due to disease?
    4. Who pays for transportation?
    5. What is the long-term viability of the buyer?
- Contract must fit the operation, and the hogs must "fit" the buyer.
- Producer must "fit" hogs to buyer's grading structure.
- Each buyer has a preference for contract type. Some are more interested than others in certain terms. May have to seek more distant buyers to get preferred contract.
- Try to contract for as short a period as possible.
- Have escape clause in contract in event the producer quits business before contract expires.
- Minimum delivery size (often semi-load lots) may limit opportunities, but some contracts are open for negotiation.
- May be limited opportunity for small- to mid-sized producer to find and contract with buyer.

Contract Variations

Three types of current long-term hog marketing contracts were briefly discussed. There are several variations of these contracts available to producers. New contract offerings appear from time to time. Buyers will also be adjusting their risk management strategies and long-term marketing contract offerings as the new CME Lean Hogs Contract, starting with the February 1997 contract, becomes the pork industry's risk management tool.

Follow Marketing Plan

Hog producers should have a written marketing plan. The producer must assess all business and personal factors that can affect his current and future decisions. Market information and data must be evaluated to assist with marketing decisions and strategies. Then if long-term hog marketing contracts fit into the marketing plan the producer should find a buyer that will pay a competitive price for the producer's hogs based on their market value.

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